No. 8994.

In the United States Circuit Court of Appeals

For the Ninth Circuit.

T. E. KLIPSTEIN,

Appellant,

vs.

HERBERT P. SEARS, Trustee in Bankruptcy of the Estate of Globe Drug Company, Inc.,

Appellee.

APPELLANT'S CLOSING BRIEF.

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APPELLANT'S CLOSING BRIEF.

Statement of the Case.

Appellee's re-statement of the case in his reply brief is in general merely a reiteration, in less complete form, of the material already supplied in appellant's opening brief. Such re-statement, however, contains one or two matters which appellant believes may be misleading and which warrant correction by reference to the record.

Following the quite accurate prefatory remark that such facts have "nothing to do with the extent of the recovery sought and awarded", appellee sets out the circumstances surrounding the execution of the note by Globe Drug Company, Inc., the action against the company by Klipstein, and the execution sale of the company's tangible assets, concluding with the statement that from the proceeds of such sale Klipstein "has withheld the sum of $608.75." (Brief for Appellee, pp. 4-5.) No portion of the transcript is cited for this last assertion. In fact, the record affirmatively shows that no attempt was ever made by Klipstein to withhold any part of such moneys.

In this connection Klipstein testified that all creditors were sent notice [Tr. p. 61] and that the proceeds of the sale, less costs and expenses, were turned over to the trustee. [Tr. p. 62.] The judgment roll of the action in question, a certified copy of which was introduced as Plaintiff's Exhibit 7 [Tr. p. 56], shows that the judgment was entered on November 8, 1935, and Sears himself testified that communications were sent out to the San Francisco and Los Angeles Boards of Trade at least as early as November 4th. [Tr. p. 64.] Bankruptcy proceedings were not filed until February 14, 1936. The disposition of the proceeds of the sale is revealed from the bankruptcy schedule filed by Stelzner on behalf of the drug company [Plaintiff's Exhibit 8, Tr. pp. 57-59], from which the following table is constructed:

Gross amount received on sale.....		$1,935.00
"Held by Brittan & Mack, attorneys, for the benefit of creditors"	$1,316.31	
"Held by D. D. Cornwell, deputy constable, to be returned for the benefit of creditors".....	565.17	
		1,881.48
Balance available for "costs and expenses"		$ 53.52

This tabulation completely disposes of the contention that Klipstein "has withheld" or over attempted to withhold the sum of $608.75 or any other sum whatsoever from the estate of the drug company, even prior to the bankruptcy petition.

Appellee's statement of the case contains the further assertion that the sum of $4,500.00 fixed as the maximum recovery by the decree was "calculated by the court to be

sufficient to pay all such claims, allowances and expenses". (Brief for Appellee, p. 5.) This is an inaccurate statement of the record. In the minute order entered by the trial court upon the conclusion of the trial [Tr. pp. 24-25] a decree was ordered in favor of the plaintiff in the sum of $4,255.54 and accrued interest, representing the sums "shown to have been illegally withdrawn and paid out by the defendants". In making and entering its formal findings of fact the trial court entirely failed to find on the issue of the existence of any creditors whose claims have been filed and approved and remain unsatisfied and this failure constitutes one of appellant's main points in seeking a reversal of the decree entered (see App. Op. Br. pp. 57-58). The schedule in bankruptcy prepared by Stelzner [Plaintiff's Exhibit 8, Tr. p. 57], lists debts aggregating $11,043.87, including a claim by Klipstein on his judgment in the sum of $5,708.90. Excluding this claim, which Klipstein directed his attorneys to waive for the benefit of creditors [Tr. p. 61], the listed debts total only $5,334.97 against assets in cash and accounts receivable of $3,985.63, making the excess of liabilities over assets as shown by such schedule $1,349.34. There is no evidence anywhere in the record that any of these listed debts were ever filed or approved or that any of the listed accounts were not collected.

It therefore appears from the record that, not only did the trial court not make any such "calculation" as suggested by appellee but that no such determination could have been made in view of the entire lack of evidence. This is of course obvious from the terms of the decree entered [Tr. p. 32] by which the amount necessary to satisfy such claims, allowances and expenses is left to the determination of the referee in the bankruptcy action.

ARGUMENT.

In his opening brief appellant Klipstein attempted to present to this Court certain propositions of law believed by him to be determinative of this appeal. Many, if not most, of these propositions remain wholly unanswered in appellee's brief and will not be further argued herein.

A considerable portion of appellant's opening brief was devoted to the proposition that the rights of the parties in this action are to be determined exclusively by the substantive law of the State of California and that the definition of such rights must be found in the statutes and decisions making up two branches of that law, first, the law relating to fraudulent conveyances and second, the law relating to the duties and liabilities of directors of corporations.

Appellee admits that the law of California governs. (Brief for Appellee, p. 12.) Appellee, further, makes little more than a desultory effort to meet the argument that the proof is insufficient to warrant a recovery under the rules of law relating to fraudulent conveyances. Indeed, appellee disclaims the necessity for such proof. (Brief for Appellee, p. 21, lines 3-9.) The only portion of appellee's brief relevant to this point is that in which it is asserted that Klipstein was chargeable with fraud. This argument has been amply covered in appellant's opening brief, wherein it is contended not only that no finding of fraud was intended but that the record is barren of the "unequivocal and convincing" evidence necessary to support such an allegation. See *Marshall v. Gelfand,* 99 Fed. (2d) 85 (C. C. A. 6th, 1938). Appellee's main contention is, apparently, that a recovery against Klipstein may be sustained under some general principles of law

existing apart from, and at least partially inconsistent with, the express statutory provisions of the Civil Code of the State of California. In arguing this proposition in general terms appellee has been frequently led astray from the precise issues presented to this Court on this appeal.

The Trustee in Bankruptcy, on the Record Presented, Is Limited to the Assertion of Rights Possessed by California Creditors and All Discussion Attempting to Enlarge Such Rights by Citation of Rules Governing the Duties of Directors to Their Corporation and Its Stockholders Is Irrelevant on This Appeal.

The irrelevancy of those portions of appellee's argument devoted to a dissertation on the duties owed by directors of corporations to their corporations or to stockholders is conclusively demonstrated by each of two propositions.

In the first place, as pointed out in appellant's opening brief, no diversity of citizenship exists in this case. The District Court has jurisdiction only if Sears has alleged and proved a cause of action under the provisions of section 70(e) of the Bankruptcy Act. (See argument in appellant's opening brief at page 26.) Unless the right to recover can be sustained under that section Sears is automatically out of court as there is no other basis for jurisdiction. The rights of creditors and the rights of stockholders, or the corporation, against directors are substantially different. Appellee must build his cause of action upon the former. It follows that the discussion

in appellee's brief upon the various rights ordinarily possessed by a trustee in bankruptcy bringing suit in a state court, or in a federal court under section 23(a) of the Bankruptcy Act, is not applicable. If Sears would have any greater rights standing in the shoes of the bankrupt corporation than he would otherwise have as a representative of creditors *such rights cannot be asserted upon this appeal.* Much of appellee's argument is rendered ineffectual by the failure to make this distinction.

A further and equally compelling reason why Sears cannot assert any rights other than those possessed by creditors is that the corporation itself has no cause of action of any kind against either Stelzner or Klipstein. Globe Drug Company, Inc., was a one-man corporation. Stelzner was the beneficial owner of all of its stock except that put in Klipstein's name as security, was the president and in sole and exclusive control of the business. Under these circumstances he was free to do what he wished with the corporate assets (*Sargent v. Palace Cafe Co.,* 175 Cal. 737, 167 Pac. 146 (1917); *Scales v. Holje,* 41 Cal. App. 733, 183 Pac. 308 (1919)), subject only to the specific and limited rights assertible by creditors in the event of insolvency (see *Dominguez Land Corporation v. Daugherty,* 196 Cal. 468, 238 Pac. 703 (1925)). Appellant brought out in his opening brief that no proof of insolvency prior to the date of the adjudication in bankruptcy had been produced and appellee does not and cannot dispute this contention.

Sears' right of recovery is therefore that given to creditors by the law of California and upon the determination of the scope of such creditors' rights the decree in his favor must stand or fall.

In the Absence of Proof of a Cause of Action Under the Rules of Law Relating Generally to Fraudulent Conveyances the Rights of Creditors in This Case Are Determined by the Provisions of the General Corporation Law.

In his opening brief appellant called attention to the significant changes in the statutory provisions of the Civil Code relating to the liability of directors. This argument is dismissed summarily by appellee in accordance with his assertion that Sears' cause of action may be based upon general principles of jurisprudence and the common law apart from the express statutory provisions. This assertion entirely overlooks the fundamental point that the Court, in deciding this case, is undertaking a *decision of first impression because based on a new and radically different law of corporations.* The present corporate law is in effect a complete corporation code, changed in many basic particulars from the somewhat fragmentary condition which characterized it at the time of such decisions as *Southern California Home Builders v. Young,* 45 Cal. App. 679, 188 Pac. 586 (1920).

> "There have been three distinct periods or eras in California corporation law. The first began in 1850 with the statutes of that year. The second began with the adoption of the Civil Code, effective January 1, 1873. The third begins with the going into effect of the General Corporation Law of 1931." (6a *California Jurisprudence* (1932), Section 1, p. 37.)

The amendment of Article XII of the Constitution of 1879, in 1930, was intended to give the Legislature a free hand in reconsidering the matters contained in various provisions of the Civil Code applicable to corporations,

enacted at different times without any unified scheme, and to prepare a new and complete corporation law.

> "The purpose of this amendment is to empower the Legislature to provide, and keep up to date, a modern system of laws for the organization and regulation of corporations, better adapted to present-day economic and social conditions than the antiquated laws we now have." (Argument printed on the ballot in support of Amendment of Article XII, quoted in *Ballantine, California Corporation Laws* (1938 Edition), Section 2, p. 2.)

Following the constitutional amendment the General Corporation Law was enacted in 1931 (Stats. & Amdmts. 1931, p. 1762), now comprising sections 277 to 413 of the Civil Code. A cursory examination of the provisions of this law with regard to the liabilities of directors reveals that the new provisions are obviously intended to cover the entire field. The conditions under which a corporation is authorized to distribute its assets, by dividends, purchase of its own stock, or otherwise, are carefully enumerated (see sections 342, 346 and 348b). The conditions necessary for relief in the event of violation of any such provisions are also carefully and fully stated in section 363 and the following sections. The effect of the new provisions is described by Professor Ballantine as follows:

> "The liability of the directors for declaring or paying unauthorized dividends, or permitting the unauthorized withdrawal or distribution of assets among the shareholders in connection with the purchase of

its own shares or otherwise, is limited to cases of wilful or negligent violations of the legal limitations. The directors in such cases, except those who were absent or who caused their dissent to be entered in the minutes, are made jointly and severally liable for the benefit of creditors and other shareholders.

"By amendment in 1933 the direct liability of directors to shareholders and subscribers was eliminated and the right of action against the directors was conferred upon the corporation or its representative for the benefit 'of the shareholders and owners of shares at the time of such violation,' other than shares upon which any wrongful payment or distribution was made, 'for the full amount of any loss sustained by such holders and owners,' not exceeding the amount of the unlawful distribution. The corporation or its representative may also sue for the benefit of the creditors for its debts and liabilities existing at the time of such violation.

"The special provision with reference to the right of recovery by the corporation or its representative against directors in case of insolvency of the corporation was also eliminated in 1933 and the corporation or its representative may sue at any time for the benefit of creditors and of share owners existing at the time of the violation other than those to whom wrongful distribution was made. Any judgment creditor or creditors whose original claim arose prior to the violation may also institute an action against any or all of the directors.

"If all the creditors existing at the time of an illegal distribution, have been paid in full, they can claim no loss and other creditors have no right of action." (*Ballantine, California Corporation Laws* (1938 Edition), Section 262, pp. 257-258.)

Appellee's attempt to base a liability on some law apart from this express provision runs into two difficulties. In the first place it is obvious that the General Corporation Law of 1931 was meant to cover the entire field of directors' liability. Appellant does not contend, nevertheless, that cases might not arise to which no express provision is applicable and that in such cases it would not be proper to resort to general principles of the common law. Nor does appellant contend that appellee is limited by the express mention of section 363 in his pleading. Of course this Court could grant any relief warranted by the facts alleged regardless of the pleading of legal conclusions. Appellee is, however, in no such fortunate position. He is attempting to go outside of the Civil Code *in one of the very situations for which the Legislature has provided the conditions of recovery.*

The case of *Southern California Home Builders v. Young,* 45 Cal. App. 679, 188 Pac. 586 (1920), cited in appellee's brief, was an action by a corporation against its directors for an illegal payment of dividends, based on section 309 in the form of that section prior to the amendment of 1929 (set out in appellant's opening brief, pages 40-41). The question on appeal from a judgment in favor of the plaintiff was whether or not the trial court had correctly excluded testimony that the defendants acted in good faith. Defendants argued that section 309 was merely a codification of the existing law under which they would be liable only for active malfeasance. In affirming the judgment, contrary to such contention, the Court

found it unreasonable to suppose that in such a codification the Legislature would limit the cases of liability to three only, thus apparently excluding other cases by implication. Section 309 must therefore have been intended to extend liability in these cases by making the enumerated acts *ultra vires* and good faith immaterial. Directors might still be held liable under the general existing law in cases *other than those expressly provided for.* This case is not authority for the proposition that the Court is free to vary the liability of directors in the situation for which express statutory provision has been made. Indeed, the reasoning of the decision makes it authority for exactly the contrary proposition.

The quotation of general statements in opinions handed down prior to 1931, such as that contained in *Winchester v. Howard,* 136 Cal. 432, 64 Pac. 692 (1902), to the effect that directors are "trustees for the stockholders and indirectly for the creditors", serves merely to confuse the issue. Directors in California have not been "trustees" for creditors in any real sense, except after insolvency, since the decision in *Dominguez Land Corporation v. Daugherty, supra,* decided in 1925, and their duties in this regard are now specifically covered by statutory enactment. As pointed out above these duties cannot be enlarged by any reference to any additional duties owed to stockholders not only because none exists on the facts of this case but also because the trustee is excluded from the assertion thereof due to the jurisdictional peculiarities *of this appeal.*

There Is a Complete Failure of Proof to Support Any Recovery Under Section 363 of the Civil Code.

In his opening brief appellant contended that there was a complete failure of proof under section 363 for two reasons, first, for lack of proof that Klipstein was a director within the meaning of that section, and, second, for lack of proof of creditors existing at the time of the alleged violations, whose claims have been filed, approved, and remain unpaid.

Appellee is unable to point to anything in the record contradicting the assertion that Klipstein had absolutely no connection with or knowledge of the affairs of the drug company except long before and again long after the entire period of the withdrawals. Nor does appellee seriously contend that Klipstein was ever a *de jure* director. A subsequent change in the law requiring stock ownership by directors could not affect his status. *Rozecrans Gold Mining Co. v. Morey,* 111 Cal. 114, 43 Pac. 585 (1896). Appellee attempts to assert that Klipstein cannot take advantage of the defect in his title to office to the prejudice of third parties. This might be true only if the elements of an estoppel were pleaded and proved. There was of course no such evidence here and in the absence of such proof Klipstein is perfectly free to assert this defense, under the rule laid down by the California court in *Regan v. Albin,* 219 Cal. 357, 26 Pac. (2d) 475 (1933).

Section 363 limits liability to cases of active participation in a wilful or negligent violation of its provisions. Even in the case of *de jure* directors only those taking an affirmative part in voting for the illegal acts are liable. Mere acquiescence, even subsequent affirmance, is not enough. (See *Ballantine,* cited *supra; Western Mortgage Company v. Gray,* 215 Cal. 191, 8 Pac. (2d) 1016 (1932).

The same facts which would prevent liability upon Klipstein even if he had been a *de jure* director also operate to prevent him from initially coming within the term "director" as used in section 363 in relation to the alleged illegal distributions and the liability asserted by Sears. Admittedly he did not participate in any way in the actual withdrawal of funds. All checks to the bank were made over Stelzner's signature [Tr. p. 43] and were drawn without any previous meeting or authorization by Klipstein [Tr. p. 53]. Indeed, under the circumstances Klipstein could not have very well questioned Stelzner's actions if he had known of the withdrawals. There is no evidence anywhere in the record that he did know the source of the payments to the bank or anything at all about the company's affairs until after the last of the payments [Tr. p. 60]. The single act of October 19, 1935, from which the company suffered no injury whatever but in fact was prevented from further depletion of its assets [Tr. p. 61] cannot operate to subject Klipstein to an onerous liability for events then past in which he took no part. *Western Mortgage Co. v. Gray, supra.* The record shows that as the result of his attempt to aid his brother-in-law, Stelzner, in acquiring the drug store Klipstein has already been subjected to a monetary loss of over $5,000.00. He never received the benefit of one penny from the company or from Stelzner for his actions. He took no part and had no interest in the business. The suggestion that he might be subject to criminal liability under section 560 of the Penal Code is ridiculous on the facts.

The second point precluding relief under section 363 and relied on by appellant as calling for a reversal in this action is the complete failure to prove and the failure of the trial court to find that there exist creditors whose

claims arose prior to the alleged withdrawals, who have proved such claims in the bankruptcy proceedings and whose such claims remain unpaid.

The cases cited by appellee to sustain his contention that subsequent creditors are entitled to recover are not in point and furthermore were all decided under the disparate provisions of the former law. *Kahle v. Stephens,* 214 Cal. 89, 4 Pac. (2d) 145 (1931), involved illegal purchases of the corporation's own stock taking place between the years 1919 and 1926. The basis of the court's decision is not clear from the opinion. In support of the statement that subsequent creditors were entitled to recover the opinion cites *Sherman v. S. K. D. Oil Co.*, 185 Cal. 534, 197 Pac. 799 (1921), and *Clark v. Tompkins*, 205 Cal. 373, 270 Pac. 946 (1928), both watered stock cases where *only* subsequent creditors would have any cause of complaint. Moreover, in the *Kahle* case the trustee, suing in the state court, could assert any rights possessed by the corporation and there was evidence of a large number of innocent shareholders. There was in addition abundant evidence of actual fraud.

Hansen v. California Bank, 17 Cal. App. (2d) 80, 61 Pac. (2d) 794 (1936), also involved an illegal purchase of stock, taking place under section 309 as it existed in 1929 (set out in App. Op. Br. p. 41). On the authority of the *Kahle* case the court found subsequent creditors entitled to recover upon the theory that the money received upon the sale to the corporation of its own stock without the consent of the Corporation Commissioner created a trust fund, the transaction being *ultra vires* and void.

Besides involving questions different from that here raised both the *Kahle* case and the *Hansen* case are no longer law in the State of California since the amendment of section 363 in 1933. The plain words of that section

as so amended restrict recovery to existing creditors. The rather lengthy quotation above set out from Ballantine entirely bears out appellant's contentions in this regard and the point will not be argued further.

Appellee makes the statement (Brief for Appellee, p. 25) that the trial court took judicial notice of the creditors' claims proved in the bankruptcy proceedings. Even if this were true it would of course not remedy the failure to show that such creditors were in existence at the time of the alleged violations and appellee does not attempt this contention. However, the assertion concerning judicial notice is clearly only an afterthought. There is nothing in the record to show that the trial court took such notice or that there were in existence records of which such notice could be taken. On the contrary the record affirmatively shows that no such notice was taken inasmuch as by the decree the amount of the recovery depends upon the report of the referee in the bankruptcy proceedings *to be thereafter filed* in the present action. An issue of fact was tendered as to the existence of unpaid creditors who had proved their claims [see Amended Complaint, paragraphs VIII, Tr. p. 8, and III, Tr. p. 10; Answer, paragraphs VIII, Tr. p. 12, and XI, Tr. p. 13]. No proof was introduced on this issue nor was the court asked to take judicial notice of any such facts. The record shows that no such notice was taken. If the trial court had attempted to supply the lack of proof by any such means the propriety of its action would have been highly doubtful. *Paridy v. Caterpillar Tractor Co.*, 48 Fed. (2d) 166 (C. C. A. 7th, 1931); *In re Interstate Oil Corporation*, 63 Fed. (2d) 674 (C. C. A. 9th, 1933).

Appellant will not further argue the effect of the decision in *In re Wright Motor Company*, 299 Fed. 106

(C. C. A. 9th, 1924), upon which the trial court based its decision in the instant case. It is felt that the unavailability of that case to support the decree herein is sufficiently set forth in appellant's opening brief and that the arguments therein contained remain entirely unanswered. The other cases cited by the appellee, *In re Dalton Electric Co.*, 7 Fed. Supp. 465 (1934), and *Lytle v. Andrews*, 34 Fed. (2d) 252 (C. C. A. 8th, 1929), are based upon the local laws of the states of Mississippi and Iowa respectively and, particularly since the decision in *Erie Railroad Co. v. Tompkins*, 304 U. S. 64, 58 S. Ct. 817 (1938), can afford little aid to appellee in this litigation.

In No Event Would the Trustee in Bankruptcy Be Entitled to Recover "Reasonable Allowances and Expenses" Over and Above the Amount of Any Unpaid Creditors Claims.

In its decree the trial court allowed recovery not only to the extent sufficient to satisfy all claims approved but also sufficient to cover all "reasonable allowances and expenses" in the bankruptcy proceedings, to be determined by a report to be filed by the referee [Tr. p. 33]. No matter what decision might be rendered on the other questions presented on this appeal the impropriety of this action is obvious. Appellee has cited no authority and appellant knows of none which could support a recovery over and above the amount of unpaid creditors claims, under any circumstances. Not only is the additional recovery legally unwarranted but Klipstein would by the decree be denied his day in court to contest the reasonableness of any items sought to be included under the vague and indefinite denomination of "allowances and expenses."

Conclusion.

This Court on this appeal from an equitable decree is confronted with the problem of considering the evidence and rendering a decision by the application to such evidence of statutory provisions hitherto not authoritatively interpreted. Yet the very questions vital to a determination of the legal issues involved are left unanswered by the proof adduced at the trial and preserved in the record. When, if ever, prior to the date of its adjudication in bankruptcy, did the Globe Drug Company first become unable to meet its obligations as they fell due? Were any claims of creditors allowed in the bankruptcy proceedings and if so, to what extent, and when did such claims accrue? These and other questions raised by the pleadings are vital to the decision in this case and are left entirely unanswered by the evidence produced by plaintiff in support of his case. Appellee now seeks to avoid this failure by wholesale inferences and resort to principles of law applied "from time immemorial" "to just such situations as this". The express statutory enactments governing such cases are apparently considered mere impediments to the application of these principles. But no law applies except the law of the State of California, determined by the statutes enacted by its Legislature and the decisions of its Courts. The principles which appellee seeks to apply seem to exist only *in vacuo,* not having their origin in the instrumentalities empowered to make and apply the substantive law of the State.

The failure to supply the conditions of relief expressly provided cannot be remedied by such vague and unsubstantial legal principles, unsupported by citation to statutes or decisions. The lack of proof on essential elements of plaintiff's case requires a reversal of the decree entered by the trial court.

Respectfully submitted,

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